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Saturday, September 05, 2009

The Coase Theorem in action

A nice illustration of the major flaw I have described in the Coase Theorem. Much of what is valuable in the above link I actually wrote in the comments and will now foreground with some minor edits:

> A music store is next door to a doctor's office. The music store would prefer (if the office of a rich doctor who wants quiet for his patients did not exist next door) to let its customers test its electric guitars at volume VM1 > 0. The doctor prefers it to be quieter (VD < VM1). Coase theory assumes that the only possible choices are within the range {VM1, VD}, i.e. any volume of electric guitar testing in between or including these two preferences. In the absence of transaction costs and given only this range, one can indeed conclude that the music store and the doctor will bargain to an efficient outcome. But these aren't the only choices. The music store can, at additional cost to itself C, turn up the volume nobs on its amplifiers and play the music at volume VM2 > VM1. If the doctor is willing to pay the music store P1 to change the volume from VM1 to VD, and P2 > P1 + C to turn the volume down from VM2 to VD, the music store has an incentive to play the music at volume VM2 instead of VM1, or to threaten same, in order to extract for itself a greater benefit from the situation.
>
> In other words, the same physical effect that produced the externality gives rise to an opportunity and incentive to play a negative-sum game. Here it changes the music store's prefered volume in the absence of a rich doctor next door from VM1, to VM2 > VM1, due to the opportunity to extort extra payments from the doctor by creating an even less bearable din, for which the doctor is willing to pay even more to avoid. The music store is willing to incur an extra cost C to itself in order to extract the greater payment P2 from the doctor. For the overall game the payment P2 is a wash and C makes it negative-sum. (In the music store example, cost C comes from the music store chasing away some of its own customers, albeit at a slower rate than it chases away the doctor's customers, by testing its guitars more noisly than it would prefer in the absence of the doctor).
>
> If, as in reality, there are transaction costs causing bargains to sometimes not be reached, the outcome is even worse, as noise VM2 is costlier, perhaps far more costlier, to the doctor's practice than VM1: such outcomes are often far worse outcome under transaction costs than the range of possible outcomes that Coaseians contemplate.

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Of course, more generally in the absence of proper prior legal allocations of rights the doctor and music store could threaten each other in other ways: the doctor could threaten to poison the guitar frets, the music store could call in the mob on the doctor, etc.

(Furthermore, even with tort law preventing these other negative-sum games the music store has an incentive to falsely "reveal" preference VM2 instead of VM1 to the doctor and to the judge -- a common problem that good tort law usually, but hardly with perfection, tackles).

The example of the music store and its amplifier volume shows that the externality itself contains potential or actual coercion -- the same physical effect that causes the externality often makes negative-sum games possible, and in the absence of any prior legal limits on the externality, opportunities and incentives for coercive negative-sum games are inherent in the externality -- so that analyses of such externalities with the Coase Theorem, which assumes such games don't exist, will often lead to misleading or false conclusions.

The game being played here by the music store is negative-sum for the same reason a tax is, firstly because the music store's coercion distorts the behavior of the doctor and his patients. Assuming the doctor is helpless to stop the noise without making the payoff (e.g. we artificially assume he can't order a mob hit on the music store, or poison its customers, or emit any other such "extreme" externality to avenge or deter the music store's excess externality) he will go golfing more, and see fewer patients, if he is paying P2 to the store instead of P1. Fewer patients will be healed, a net loss of welfare. Since we assume the music store is rational, it will demand only the Laffer-maximum amount of extortion, but Laffer-maximum taxes still have plenty of distoritve effects that produce inefficiencies compared to the no-taxation case. Secondly, the behavior of the music store is also distorted because it has excess profits to spend. It will invest its extra money in opening new music stores and concert halls next to other doctor's offices, nursing homes, and similar because that is a lucrative source of profit, and so other activities that would prefer quiet will be distorted in turn. It is often unreasonable to assume that Coaseian payees are spending their extra money efficiently. Interestingly, Gary Becker assumed the Coaseian payor's behavior was not distorted and that the Coaseian payee was spending its extra profits efficiently, and used this Coaseian reasoning to argue that governments themselves are efficient outcomes of Coaseian bargaining. Becker's argument is wrong for the same reason that [anarcho-capitalist David] Friedman's [Coaseian] argument is wrong for legal protection agencies: it doesn't account for the economic distortions caused by coercion.

To see where these negative-sum games lead, let's take the case of roving loudspeakers. Pickup trucks drive through the city, parking in front of every business in turn and demanding large payments to take their noise elsewhere. The optimal extortion for the extortors in this case is nearly 100% of all business wealth in the city (again assuming the victims are defenseless), because if extortor A doesn't extort any remaining wealth extortor B will be happy to come in and take it. The economy is so distorted that practically nothing gets produced or distributed and the city's economy collapses. This is the "roving bandit" case studied by Mancur Olson. Where two stores are next to each other and neither can move constitute "stationary bandits", as do gangs or governments with "monopolies of coercion" over fixed territories. As the roving loudspeakers case illustrates, rational stationary bandits collect a far lower percent of their victims' profits in taxes than do roving bandits. (But stationary bandits with the much lower rate than 100% end up collecting a far higher absolute amount -- recall the Laffer curve) . If on the other hand we assume the victims are not defenseless, we have negative-sum games like hawk/dove, negative tit-for-tat, etc. which again are paradigmatically very different from voluntary Coaseian bargains.

We can measure the effectiveness of an excess (or coercive) externality for extracting super-Coasiean payoffs by how great a harm the externality can produce for the least cost to the emitter. The ubiquity of technology that is very effective in producing the greatest harm for the least cost, i.e. weapons, in our world should be a very good clue that our

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world is not Coaseian. Music volume, spark emission, and so on beyond the "preferred" level Coaseians falsely assume to be maximal are logically weapons. Their harm/cost ratio is lower than guns, tanks, bombers, missiles, flamethrowers, herbicides, and so on, but they have an advantage in being physically hard to distinguish from merely Coaseian externalities, which would come in handy in a world where judges and other lawmakers actually based law on the Coase theorem (the good news is that they mostly don't).

Posted by Nick Szabo at 12:34 AM

33 comments:

nazgulnarsil said...

so would this (minimizing these cases) serve as an example where tort law can not be formalized into contract law? I'm still having trouble understanding how tort law differs from implicit contracts that could be made explicit if we chose.

2:58 AM

nick said...

This comment has been removed by a blog administrator.

2:03 PM

nick said...

Try again. :-)

Nazgulnarsil, I'm in the dark as to how you link "implicit contract" to tort law. I can only imagine that you might be referring to implied-in-law contracts. The canonical one is that if you are unconscious and a doctor helps you, you owe the doctor a reasonable fee.

Implied-in-law contracts are a very narrow exception to the otherwise universal rule that one must actually form a contract for their to be an obligation to pay for a service. If a gardener comes uninvited and starts mowing your lawn, or a windshield wiper comes up to your car on the street and stars wiping, you don't legally owe them for either their putative or actual services. (In some jurisdictions if you know they are providing the service and don't object, a contract can be imputed, but these can be considered cases of tacit consent). These people who provide services uninvited are called in many jurisdictions "officious intermeddlers" becausing they are presuming to know what you want rather than negotiating a contract. (Come to think of it, "officious intermeddler" is a good description of many government officials as well).

Even less does somebody committing a tort against another create a contractual relationship. Your rights, to the extent you have them, to be free from the noises of strangers is a matter of tort law (the law of nuisance), not of contract law -- you can't (except for that doctor) have contractual relationships with complete strangers.

4:43 PM

nazgulnarsil said...

This comment has been removed by the author.

5:39 AM

nazgulnarsil said...

okay I think you answered my question. I can't see a way out of having governing bodies on a small scale (homeowners associations with teeth :) that can enforce tort law.

5:47 AM

Alrenous said...

The doctor's office and the music store do not form simultaneously.

If the music store exists first, the doctor would not put their office there, instead choosing a noise-free location, unless they can obtain an agreement to lower the volume.

If the office exists first, the music store has a moral obligation not to unilaterally impose harmful externalities for its own enrichment.

So, what did I do wrong? (For example, my understanding of Coase may be shaky.)

6:48 PM

nick said...

Alrenious:
If the music store exists first, the doctor would not put their office there, instead choosing a noise-free location, unless they can obtain an agreement to lower the volume.

This is fine insofar as we can assume that contracts are enforced. (Normally we can, unless we are trying per Friedman or Becker to invoke Coase to explain either why we don't need governments or why governments are a good solution to the problem -- such invocations of Coase are fallacious because Coase assumes voluntary transactions, which can't be assumed unless good law already exists).

While I generally favor the "first there wins" rule of nuisance, because as you observe (absent transaction costs per Coase) it can allow Coaseian bargaining, various transaction costs such as the contract incompleteness problem (can a contract identify and deal properly with all potential threats?) often make it impractical. Perhaps for this reason real nuisance law doesn't always favor the first resident. However, I'm reasonably comfortable with invoking the Coase Theorem in this case, assuming good contract enforcement institutions already exist, in order to emphasize the importance of transaction costs (like contract incompleteness) as Coase did and his wiser followers have.

This one is the bigger problem:

If the office exists first, the music store has a moral obligation not to unilaterally impose harmful externalities for its own enrichment.

It's fine to invoke moral obligations until the cows come home, but that does not mean people will follow them. I have shown that, absent good tort law, it is in the rational self-interest of the music store to impose such externalities even to the point of turning them into low-cost threats (weapons). And the theory seems to describe the real-world behavior of mafias, pirates, governments, and other coercive institutions, whereas Coase-based theorems (and economics generally) run into huge problems when dealing with coercive phenomena, because economics has traditionally and usually tacitly assumed voluntary transactions, which in turn requires a

sophisticated legal system. Many, including too many economists, fail to realize this and invoke these theories where good legal systems can't be assumed.

10:13 PM

Erin H. Yu said...

One problem is that there is no well-defined version of the theorem (that I know of - I didn't look very hard). If:

1. No assets are created or destroyed (just "used" or "unused");

2. Every asset (when in the possession of a particular person) has exactly two possible sets of effects (the externalities that arise when the asset is used, and nothing when it is unused); and

3. The total number of assets is finite,

then the music store example would not work. The music store possesses an asset that allows it to make volume VM1, and it also possesses an asset that allows it to make volume VM2 > VM1. However, since it has only a finite number of assets, the office can pay the store not to use assets VM1, VM2 .. VMn.

Of course, in real life, the music store would be able to play a continuous range of volumes, but the volume is still bounded (the sound waves can't contain more energy than the total amount of energy in the universe, for instance). You can group all possible volumes into a finite set of volume ranges 0 <= VM0 < 1, 1 <= VM1 < 2, etc. Therefore, the doctor can pay the store a finite amount of money in order to make it stop playing in the most annoying volume ranges.

(In general: if there is an upper bound on the amount of harm that can be done, you can partition "amount of harm" into multiple ranges that can be negotiated about.)

5:03 PM

Erin H. Yu said...

(The doctor would have to pay a lot of money, but the end result would still be efficient.)

5:06 PM

nick said...

Erin, economic assets often are not fixed. Here the music store has a cheap way to threaten (and if necessary carry out the threat) to destroy one of the doctor's major assets, namely the office location and its attractiveness as a place to heal (there's enough energy even in one good guitar amp to destroy that).

Similarly, the railroad can use sparks to cheaply destroy an asset of the farmer (his field). More generally, militaries can cheaply destroy the assets of their enemies -- one of the major things militaries traditionally did, when agriculture was a much bigger part of the economy, is destroy the enemies' crops. And weapons make it cheap to destroy the ultimate asset, life. One consequence is that one also needs weapons to protect against such destruction.

Also, even if transaction costs are zero and a deal is made every time, the doctor has to give away most of his profits to pay the extortion money to the music store. That changes his behavior. Maybe he moves, at some cost to himself and his patients. Maybe, anticipating how vulnerable doctors are to such extortion absent good tort laws, he goes into some other line instead of investing all the time and money it takes to get through medical school. That change of behavior of victims of extortion also destroys or stops the creation of assets (such as in this case the number of doctors trained to heal us). That change in behavior and the resulting destruction of value is what the Laffer Curve is about.

BTW here's a good set of lectures on the Laffer Curve:

http://www.youtube.com/watch?v=fIqyCpCPrvU&feature=related

(h/t Noreen Alladina)

You'll be thankful that it's a more interesting lecture on that topic than this one:

http://www.youtube.com/watch?v=lWzMyKSIbFY&feature=related

It's a sad entropic fact of the world that destruction is far easier than creation.

9:23 PM

Eric(n) Yu said...

Nick,

If the amount of damage any one person can do is finite, a potential victim can dissuade the person from doing bad things by paying them a finite (possibly very large) amount of money. It is very reasonable to assume that everyone's damage-dealing capability is bounded.

Also, even if transaction costs are zero and a deal is made every time, the doctor has to give away most of his profits to pay the extortion money to the music store. That changes his behavior. Maybe he moves, at some cost to himself and his patients. Maybe, anticipating how vulnerable doctors are to such extortion absent good tort laws, he goes into some other line instead of investing all the time and money it takes to get through medical school. That change of behavior of victims of extortion also destroys or stops the creation of assets (such as in this case the number of doctors trained to heal us). That change in behavior and the resulting destruction of value is what the Laffer Curve is about.

If the doctor won't go there the store can't extort any money, so the store will lower its "price" until it is worthwhile for the doctor to set up shop next to the store. The store knows how much the doctor is willing to pay because the Coase theorem assumes perfect information.

(Obviously, if the doctor could have his office be somewhere else there wouldn't be a problem in the first place and the doctor wouldn't be affected by the store. If the store tried to make the doctor pay, the doctor would build somewhere else.)

10:26 PM

Alrenous said...

Nick,

A very thorough answer. Thank you.

8:43 AM

Peter McCluskey said...

I think you misunderstand what Coase meant by zero transaction costs. All your examples of negative sum games appear to result from nonzero transaction costs. If you exclude costs of coercion from the concept of transaction costs, I don't see how that concept remains meaningful.

My understanding of the Coase Theorem is that it demonstrates the importance of transaction costs. I'm disappointed by the number of people (e.g. David Friedman) who imagine it says we live in an almost efficient world.

8:00 AM

Alrenous said...

Did the colonial articles of incorporation also depend on tort law?

("In Africa, by sharp contrast, the main business was slaving, and the charters of the African corporations authorized them to wield martial law, which they did with ruthlessnes.")

3:15 PM

nick said...

BTW, one consequence of the broad definition is that the supposedly profound insight about the importance of transaction costs turns into "bad things that can happen to economic transactions are important to the economy", which does not sound very profound to me (in patent-lingo it would be called "obvious"). I do observe that too many politicians and even academics ignore such obvious points, but that is a problem of rhetoric or education, not of theory.

Using confusing language does not help in this educational task. The reality distortion occurs when economists, because "transaction costs" traditionally means something far narrower and very different than many other kinds of "bad things", take the bad things that can happen to transactions to be like broker's fees that can be reduced through better information and the like. The most important bad things that can happen to transactions, namely the coercive ones, may not be amenable to such solutions or may be amenable to them applied in radically different ways (and note that economic theories of asymmetric information, transactions in which information reduces transaction costs, are as usual assuming voluntary transactions and can't be readily used in the coercive case).

3:17 PM

Eric Yu said...

I don't see coercion as a transaction cost, but as an externality, and I think it (ideally, not in reality) can be analyzed as one. Here is the justification:

A transaction cost is incurred during a transaction, by definition. Clearly, it is possible to sell weapons with arbitrarily low transaction costs, so the impact of weapons isn't because of transaction costs.

An externality is something that happens to other people when you do something (broadly speaking). Pollution is an externality because an agent that decides to pollute will directly affect others (without their permission). Weapons are similar to pollution except for the fact that weapons produce externalities much more cheaply.

Basically, I'm saying there isn't a qualitative difference between coercion and pollution; it's just a matter of degree. You could buy a polluting device and coerce people with it, too, if it produced enough pollution.

3:34 PM

nick said...

Alrenious, the colonial charters crucially included grants of political properties, in the positive form of rights to coerce others, as in the case of the power to impose martial law in Africa. These are not contracts from the point of view of those over whom these political powers are imposed: they are "offers you can't refuse."

From that point of view (and sometimes from others) these charters were more like treaties than contracts. Contracts by law must be based on voluntary negotiations, whereas treaties are often based on coercive ones -- the difference is crucial, which is why there are very different bodies of law for each.

However, charters were not primarily viewed as either contracts or treaties, but as property deeds -- in the case of colonial charters, grants of land and political property from the king, later with the consent of Parliament, to subject(s) who petitioned (and often paid) for such a grant. (Less commonly, at least in the king's records, are further grants of political property from the king's grantees to others -- like the Crown itself, there was generally no "aftermarket" for buying and selling political properties, albeit in the colonial era one could buy and sell shares in many of the colonial companies, and the East India Company was a big part of the early British stock market).

If some other party interfered with these political property rights -- usurped them or prevented them from being exercised -- the King's courts would have jurisdiction to hear the case. (The King being considered or in fact the grantor of political properties retained jurisdiction over disputes over such properties). Traditionally in English law this would have been dealt with as a matter of "trespass", i.e. as what we now call a tort. (In fact, a large proportion of early tort/trespass cases were over political property rights -- late medieval English kings didn't have jurisdiction over much else besides that and the army). The usage, with the idea of political property rights, has now become archaic, largely metaphorical -- political property laws have now been revoked or fallen into disuse, government having been converted to the Roman model of a near-monopoly over coercive powers.

The claims I'm making about tort law related to Coase may be a bit different. I'm claiming that normal negotiations and contracts that Coase was talking about, among voluntary economic actors, i.e. the kind you need to approach efficient markets, or where the main costs are usefully analogous to broker's fees, depend on a sophisticated existing tort and property law to minimize coercion including the use of nuisance/externality phenomena in a coercive way (e.g. turning up the volume beyond what the music store would without the doctor's office next door have preferred in order to extract an extortion premium from the doctor in their Coaseian negotiation).

Where coercion and political process are involved, all sorts of things happen that voluntary-transaction-assuming economics usually does not model well. That includes the old system of political property rights. (It's a mistake to think they automatically led to market-like outcomes -- sometimes they did, as in the case of the market fair courts, but just as often they led to coercive monopolies like the guilds who had political powers to coerce competitors).

4:01 PM

nick said...

If you exclude costs of coercion from the concept of transaction costs, I don't see how that concept remains meaningful.

The phrase "transaction costs" comes from the world of brokers. It suggests something analogous to a broker's fee: a cost of bringing parties together, a cost of haggling, or similar.

Coercion is not usefully analogous to a broker's fee. You don't merely add it on to the cost of doing business. It's a paradigmatically different thing, creating crucially important negative sum games that Coase theorists ignore (either by definition or by assumption). One chooses one's brokers, but not one's bandits -- the broker fee might be so high that you choose not to transact, but there is no "offer you can't refuse" -- there is no coercive negative sum game. Brokers provide a service not a lack of action for their fee, and multiple brokers cannot come along and charge you for withholding action. The coercion and negative sums of the game persist, and may even get worse, when the parties are better informed, whereas broker's fees and analogous costs fall when parties are better informed. These are very profound differences between the two cases. To pursue analogies between them is to engage in outrageous distortion of reality.

A broad definition of "transaction cost" as "anything bad that can happen to a transaction" also reduces the theorem to a tautology, or a mere restatement of the assumption of the neoclassical market model: if nothing bad happens to the transaction then the outcome is efficient.

Coercion is the most important thing economic models such as those used to "prove" the Coase theorem generally assume does not exist. The result is that economic models generally only work in systems with sophisticated property and tort law. Taking the most disparate bad outcomes and sweeping them under the rug of "transaction costs" is a preposterously misleading exercise if one is trying to understand how the interhuman world works. Even worse, is to, as the broad-definition Coaseians often do, think that transaction costs, despite being so broadly defined, can like broker's fees simply be reduced with sufficiently informed people or computers with sufficiently clever programming. Worst of all is using the theorem to explain the emergence (Becker) or unnecessariness (Friedman) of the institutions that may reduce coercion and thereby make the voluntary transactions that Coasians assume normal in the first place. It's logical tail-chasing of the worst variety.

4:24 PM

nick said...

Eric, that's a pretty good summary of what I've been trying to write.

4:26 PM

Eric Yu said...

Eric, that's a pretty good summary of what I've been trying to write.

But you say that the Coase theorem as it is usually stated is false, while I say that it is true. I wrote the last comment to explain why I think the theorem is true, but you said I'm just summarizing you. Maybe you're saying that the Coase theorem is technically true but when externalities are too cheap to create tort law is by far the best solution to controlling those externalities. I'm confused...

8:35 PM

Alrenous said...

Again, thanks.

10:32 PM

nick said...

Eric, perhaps your summary was a bit too brief then. :-) I thought you expressed the close link between externality and coercion very well and that's what I was agreeing with. If I append the following two paragraphs to the end of your penultimate message whereof I spoke, I would agree with it (but it would contradict what you just said):

The Coase theorem is false because it assumes voluntary transactions. (Whether this is part of the zero transactions costs assumption or a separate assumption, the assumption is there). But it also assumes that any prior allocation of rights is possible, including rights that allow one party to coerce another. These assumptions contradict each other, thus the theorem is false. I gave the example of the music store which demonstrates that it doesn't work in real-world situations as well. (One can also observe the behavior of mafias, governments, etc. to see that this is so: coercive relationships follow very different patterns than voluntary ones. The set of big differences between contract law and treaty law is another example of this). If externalities and coercion are equivalent, Coaseian negotiations can't solve any externality problems (except by coincidence -- i.e. negotiations won't have the outcomes they do for Coasian reasons).

If externalities and coercion are not disjoint, then there are some externality problems Coaseian negotiation can't solve (i.e. ones that can also be coercive). Since I've shown it's easy to convert a mere externality into a coercion, and thus a Coaseian bargain into an extortionate one, by converting the mere Coaseian externality into a weapon, even with zero noncoercive transaction costs the ability of the Coase theorem to handle even such pedestrian externalities as sparks, pollution, noise, and so on is limited, and can at best only be used if additional steps (probably legal steps, as in tort or criminal law) are taken to eliminate coercive regimes (e.g.

the music store turning up the volume more than it would have otherwise preferred, the railroad spending a bit extra to emit many more sparks, threatening people with guns, and so on).

Not very snappy as a summary, alas.

10:45 PM

Eric Yu said...

Nick, do you disagree with any of these assertions?

1. All transactions that ideal agents make are technically voluntary, just overwhelmingly favored. Externalities are not transactions.

2. In the case of the mafia, the people being victimized by the mafia don't have enough money to pay the mafia to stop victimizing them once and for all. If everyone could spend as much money as they wanted (but lose utility proportional to the amount of money spent) the mafia would go away. Also, the victims don't have perfect information on the mafia.

3. The music store example is efficient after an initial transfer of a finite amount of money. If the store can only play music up to a certain maximum volume VMmax, and the total utility of the doctor (assume the store's utility is constant) is maximized at volume VMbest, then the doctor will pay up to (doctor's utility at VMbest) - (doctor's utility at VMmax) in order to get the store to play music at VMbest. The amount of money transferred may be large, but the store will eventually agree to play at the optimal volume for the doctor. If you also consider the store's utility, the analysis would be more complicated, but it would most likely yield the same result.

4. Coercion and externalities can be treated as different in real life because coercion can have much larger direct effects and doesn't have a significant direct benefit to the coercer.

9:26 AM

Daniel A. Nagy said...

I think, I am having the same problem as Eric with your music store example: the end result is not a negative-sum game, because it is not in the interest of the music store to carry out the threat as long as the doctor pays.

If maintaining a credible threat has a measurable cost, like in the extreme and fairly clear-cut case of weapons the assumption of perfect information does not make sense, as all parties become highly motivated to mislead one another. This is, by the way, a recurring flaw in Moldbug's arguments: there is no such thing as a completely defenseless subject, because misleading the master is always an attractive option.

Unlike ethology, the economics of bluffing did interest me enough to do some back-of-the envelope calculations with some semblance of academic rigor.

With this in mind, the arguments (from both sides) about the planned American missile defense systems in Eastern Europe are comically stupid.

3:00 PM

nick said...

All transactions that ideal agents make are technically voluntary

"Ideal" only in a very idealistic moral sense that depends on a sophisticated legal system to have a basis in social reality. Otherwise it's nowhere close to reality. How many transaction in nature are voluntary? It's a dog-eat-rabbit and a rabbit-eat-grass world, and that can be only changed with something highly artificial and non-obvious to nature, e.g. a highly sophisticated system of tort and

property law.

Market and related transactional models of economics rest assume such voluntary transactions, and thus assume a sophisticated legal system, which is why I generally reject them, at least out-of-the-box, as explanatory devices for phenomena operating outside that legal regime, including explaining the nature or origins of that regime.

Rational self-interest I do take as a far more generally applicable assumption of economics, but that is an extremely different thing than supposing all actions are voluntary.

Another useful model is the Byzantine or security model, where you expect and protect against the worst possible behavior your fellow humans could possibly dish out.

Neither the rational self-interest model nor, obviously, the Byzantine model, have the corollary of voluntary transactions. That requires far more, e.g. that highly evolved legal system.

Generally I'm willing to accept the rational self-interest model, although the pure Byzantine security standpoint is sometimes also valuable if it's hard to judge what would be in their self-interest or if it's probably in their self-interest to attack.

In the above analysis, I've been using the rational self-interest model, although if we pursued it further we'd need to use the security model to determine the credibility of threats and outcomes of what we might call "mutual exchanges of externality" :-)

If everyone could spend as much money as they wanted (but lose utility proportional to the amount of money spent) the mafia would go away.

The premise is hopelessly imaginary, and the conclusion is wrong anyway. Some preferences are relative, and thus insatiable, especially those satisfied by zero- or negative-sum power games, and so the mafia would keep on collecting regardless of how much it already had. The same applies to the music store, although without preexisting legal rights they (or the doctor, or both) would end up using guns instead of mere guitar amps.

(This latter also responds to Daniel's point).

10:18 PM

Eric Yu said...

So you're saying the Coase theorem is true for ideal situations but not very applicable to reality? I've basically been saying the exact same thing.

10:22 PM

nick said...

BTW, lest there be any confusion here, I mean "regime" by analogy to the way scientists use the term: e.g. in physics one can be in the quantum regime where quantum mechanics applies, in the intermediate regime where Newtonian models are sufficient, or in the relativistic regime. It's also analogous to phases of matter: in the solid regime, or gas, or plasma, or so on. Thus modern market economies operate in a regime of sophisticated tort, property, etc. laws, but many other human activities have not or do not, so that the laws of the voluntary-transaction regime of economics often do not apply.

I am not using "regime" in the sense of referring to any specific governments, and perhaps not even to government generally.

10:35 PM

nick said...

Eric, that's another way to look at it, as a tautology -- trying to address a very non-ideal situation (externalities with their intimately related possibilities of coercion) by assuming everything is already ideal.

If, however, we ignore the tautology, we actually find the Coase Theorem has contradictory premises, and thus is false, as I have described.

Either way, trying to use such a theorem to prove something about the social world is incredibly silly.

10:47 PM

Eric Yu said...

If, however, we ignore the tautology, we actually find the Coase Theorem has contradictory premises, and thus is false, as I have described.

This is the part that confuses me... Are you saying that the theorem, even in an ideal world, is false, or just that it is false when applied to anything resembling reality? I've been saying that it ***is*** true and non-contradictory in an *ideal* world.

10:24 AM

Anonymous said...

Nick:

I think what you need (or someone needs) is a clean term and definition for half-voluntary transfers. No help from me -- no good with names.

A "half-voluntary transfer" is trying to capture the following notion:

- (1) outflow of goods is always voluntary; even at the point of a gun your decision to hand over your wallet is voluntary, in the sense that you have to choose to do it

- (2) inflow of "goods" is always involuntary; you can't really "decline delivery" of a fist-to-the-face, or noise pollution in your example

In situations that count as "voluntary exchange" in conventional formulations #2 is irrelevant; I'm voluntarily providing you with something in exchange for something else, and the transaction wouldn't be happening if you didn't want my offering, so the fact that you can't really decline to take it is irrelevant.

If you have a clean term -- and internalize the worldview it implies (which you have) -- you now have a simpler, more axiomatic explanation you can use vis-a-vis Coasean bargaining:

- valuation is subjective (agents can -- and do! -- disagree about the value of some item)

- there's nothing intrinsic in nature that'd stop a particular agent's valuation of something going below zero, into negative utility

- ERGO if an agent can profitably produce a good of negative utility to another agent (profitable == for less than it's worth to the other agent to pay to get rid of it) then it's rational for the first agent to so do (even if it's a systemic loss)

Torts in the abstract provide a mechanism for shutting down the negative-sum game; in the abstract torts allow one agent to point out that another agent is producing goods of negative utility to the first agent and seek redress.

The effect of such a system is to rule out large areas of the space of produceable goods.

It's not sufficient to constrain the space of produceable goods to goods that're guaranteed to be of non-negative utility to all agents.

You don't really want that, either: valuation is subjective, and I suspect that

- my fundamentalist neighbors disliking my unmarried lifestyle shouldn't open me to a tort (but why not?)

- my competitor introducing a better product into the marketplace shouldn't open him to a tort from me (but why not?)

...and so on; a reasonable tort system will provide no redress to those negatively impacted by many actions.

Tort law as it exists is an evolved system of rules-of-thumb that do a decent job of lopping off some of the most-negative chunks of the space of possibilities.

If there's a well-defined theory of how to set up a tort system I'd love to see it.

1:47 PM

James A. Donald said...

If a protection agency is engaged after a dispute occurs, it has an inefficient incentive to engage in negative sum activities - to shake down everyone involved.

If, however, people engage protection agencies before a dispute occurs, under an insurance style contract, wherein the protection agency protects its client in a dispute at no additional fee, then everyone's incentives are for positive sum activities. See my discussion of this problem

1:05 AM

James A. Donald said...

For some reason my link to my discussion of this problem got deleted. Inserting it, therefore, in plain text: http:/jim.com/anarchy

If protection agency contracts are agreed in advance of a dispute, incentives are aligned, and incentives are for positive sum activities. If agreed after a dispute, incentives are for negative sum activities.

5:55 PM

Alrenous said...

Took me quite some time to understand that one.

I find Coase's result interesting, but it is indeed contradictory.

Take the limit. Assume an ex ante right distribution that includes the right to dictate the contract terms of a second party.

Uhh...oops. Game over.

8:53 AM

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